

# ANALYSIS OF ORIGINAL BILL

## Franchise Tax Board

Author: Mullin Analyst: Marion Mann DeJong Bill Number: AB 743  
Related Bills: See Legislative History Telephone: 845-6979 Introduced Date: 02/19/2003  
Attorney: Patrick Kusiak Sponsor: \_\_\_\_\_

**SUBJECT:** NOL Deduction/Corporations That Develop or Market Biomedical Products May Transfer Unused Loss to Another Corporation

### SUMMARY

This bill would allow corporations that incur net operating losses (NOLs) from the development or marketing of biomedical products to transfer the NOL to another corporation.

### PURPOSE OF THE BILL

According to the author's office, this bill is intended to provide an incentive for companies to continue developing biomedical products in this state rather than selling the product to a company located outside of California.

### EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would become effective immediately upon enactment and would be operative for taxable years beginning on or after January 1, 2003. However, the transferee corporation could not deduct the NOL until the 2004 taxable year because the NOL deduction is currently suspended.

### POSITION

Pending.

### Summary of Suggested Amendments

Amendments are needed to resolve the "Implementation Considerations" discussed below before the department can implement this bill. The author's staff has indicated that this is a spot bill that will be further developed. Department staff is available to assist the author with necessary amendments.

### ANALYSIS

#### FEDERAL/STATE LAW

Simply stated, NOLs are beneficial tax rules for losses that allow a taxpayer to deduct (offset) those losses in other years when the taxpayer recognizes income. These NOL rules are designed to mitigate the occasional harsh effects of the annual accounting concept applicable to the tax law.

Board Position:

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<input type="checkbox"/> N	<input type="checkbox"/> OUA	<input checked="" type="checkbox"/> PENDING

Department Director  
Gerald H. Goldberg

Date  
03/28/03

Federal law provides, in general, that an NOL can be carried back two years and forward 20 years. Special rules are provided for the carryback of NOLs arising from specified liability losses, excess interest losses, casualty or theft losses, disaster losses of a small business, and farming losses. An NOL is defined as the excess of allowable deductions (as specifically modified) over gross income computed under the law in effect for the loss year.

Generally, an NOL may be carried back or forward only by the taxpayer who sustained the loss. After a reorganization or other change in corporate ownership of the taxpayer, the future use of NOL carry forwards are limited or prohibited.

Existing state law conforms to the federal computation of an NOL, except for the following modifications: California does not allow NOL carrybacks. In addition, depending on the type of taxpayer or amount of a taxpayer's income, the percentage of the NOL that is eligible to be carried forward and the number of years it can be carried forward varies. State law also conforms to the limitations and prohibitions of NOL carryovers after a reorganization or other change in corporate ownership.

For most taxpayers, the computed NOL may be carried forward for 10 years as follows:

- For taxable years beginning on or after January 1, 2000, and before January 1, 2002, 55% of the NOL may be carried forward.
- For taxable years beginning on or after January 1, 2002, and before January 1, 2004, 60% of the NOL may be carried forward.
- For taxable years beginning on or after January 1, 2004, 100% of the NOL may be carried forward.

All deductions for NOLs for the 2002 and 2003 taxable years have been suspended. However, taxpayers may generate an NOL during the suspension that may be applied when the suspension is removed. The carryover period for NOLs incurred in taxable years before January 1, 2002, is extended by two years. The carryover period for NOLs incurred in taxable year 2002 is extended by one year. For taxable years beginning on or after January 1, 2004, the NOL carryover percentage will be 100% of the loss.

New businesses that are engaged in a trade or business activity that first commenced in California on or after January 1, 1994, are provided special NOL treatment. They are allowed to carry forward 100% of the NOL incurred during the first three years of business. This "new business" special NOL treatment also applies to taxpayers engaged in certain biopharmaceutical activities for taxable years beginning on or after January 1, 1997, that have not received approval for any product from the U.S. Food and Drug Administration.

### THIS BILL

This bill would allow a taxpayer to transfer NOLs that are attributable to the development or marketing of any biomedical product in California to another corporation. The transferee corporation must continue to develop or market that product.

## IMPLEMENTATION CONSIDERATIONS

The following implementation concerns must be addressed before the department can implement this bill. Additional concerns may arise as the bill is further developed.

- This bill provides for the transfer of an NOL that is attributable to a specific product. An NOL is the excess of deductions for the current taxable year over gross income, which is determined on an entity basis and not on a product basis. A taxpayer could have a product with a loss and have overall net income. Attributing a loss to a specific product would require the taxpayer to keep detailed records that are generally not required for other purposes. In addition, the bill would need to specify how to determine the product loss eligible for transfer under this bill so that certain expenses, such as overhead, can be properly attributed to that product.
- The bill does not define “development,” “marketing,” or “biomedical product.” Without these definitions, it cannot be determined if a transfer of an NOL would qualify under this bill. In addition, undefined terms can lead to disputes between taxpayers and the department.
- It is unclear how requirements for special NOL treatment would apply to transferee corporations under certain circumstances. For example, 100% NOL deduction is allowed for taxpayers conducting activities within an enterprise zone. Must the transferee corporation conduct activities within the zone to receive the NOL?
- The bill does not specify whether the transfer of the NOL would impact the carry forward period. Without clarification, the department would assume that the remaining NOL carryover period for the transferor corporation would apply to the transferee. Clarification of this issue would prevent disputes between taxpayers and the department.
- The bill does not specify how the transfer is to be made. Further, it does not specify whether the transfer of an NOL would be a tax-free transaction if consideration is paid by the transferee to the transferor (whether cash, other property such as stock, or in debt assumption), or what basis (value) the NOL will have for the transferee. Disputes may arise between taxpayers and the department as to the proper tax treatment of any consideration paid in connection with the transfer of an NOL under this bill.
- It is unclear what would happen if a taxpayer transfers an NOL and the NOL is partially or completely disallowed in a subsequent audit by the department. The bill should clarify the department’s legal authority to adjust the tax liability of the transferee and reclaim the NOL deduction amount, with interest, from the transferee, especially if the transferor is either no longer in existence or no longer subject to California’s taxing jurisdiction. Moreover, since there may be occasion where the department’s audit of the transferor taxpayer’s return may occur after normal expiration of the statute of limitations (i.e., under a waiver), it might become necessary for the department to request waiver of the transferee’s statute of limitations to prevent the department from being foreclosed from adjusting the transferee’s tax liability when the department determines that part or all of the claimed NOL deduction should never have been allowed. Further, the department would need to be specifically authorized to disclose the necessary confidential tax information of the transferor to the transferee if such situation arose. Conversely, the transferee would statutorily need authorization to obtain tax information from the transferor about the circumstances surrounding their claiming of the NOL that was transferred in order to defend a subsequent proposed adjustment by the department.

## LEGISLATIVE HISTORY

AB 234 (Corbett, 2003/2004) would allow a special NOL for a taxpayer engaged in biopharmaceutical or other biotechnology business activities. This special NOL would allow a 100% deduction with a 20-year carryover

AB 1654 (Houston, 2003/2004) would allow corporations to sell NOLs to another corporation.

AB 2065 (Oropeza, Stats. 2002, Ch. 488) suspended all NOL deductions for the 2002 and 2003 taxable years, extended the carryover period for the suspended years, and increased the carryover percentage to 100% for tax years beginning on or after January 1, 2004.

SB 38 (Lockyer, Stats. 1996, Ch. 954) added taxpayers engaged in certain biopharmaceutical and other biotechnology business activities to the definition of "new businesses," allowing them the special NOL deduction of 100% for the first three years.

## OTHER STATES' INFORMATION

The laws of *Florida*, *Illinois*, *Massachusetts*, *Michigan*, and *Minnesota* were reviewed because their tax laws are similar to California's income tax laws. It could not be determined if these states provide special NOL treatment for taxpayers engaged in biomedical activities. However, these states do allow the following general NOL treatment:

*Florida* income tax law, with respect to corporations, provides a 20-year carryover period but no carryback, and otherwise conforms to federal NOL laws. *Florida* has no personal income tax.

*Illinois* income tax law conforms to federal law regarding NOLs.

*Massachusetts* income tax law does not allow NOL treatment for personal income taxpayers, but corporations are allowed a 100% NOL that applies to the first five years of the entity's existence.

*Michigan* income tax law conforms to federal NOL laws, including the allowance of NOL carrybacks for corporations. However, *Michigan's* personal income tax law does not allow NOL carrybacks.

*Minnesota* personal income tax law conforms to federal NOL laws, while corporate taxpayers determine NOLs pursuant to federal law but have no NOL carrybacks and only a 15-year carry forward period.

## FISCAL IMPACT

The department's costs to administer this bill cannot be determined until implementation concerns have been resolved.

## ECONOMIC IMPACT

### Revenue Estimate

The revenue loss of this bill is estimated to be as shown in the following table:

Estimated Revenue Impact of AB 743 Introduced February 19, 2003 Effective for tax years Beginning on or After 1/1/2004 \$ Millions		
2004-05	2005-06	2006-07
-\$45	-\$45	-\$50

This estimate does not consider the possible changes in employment, personal income, or gross state product that could result from this bill.

### Revenue Discussion

The revenue impact of this proposal would depend on the amount of accumulated NOLs transferred for which more NOL deductions are claimed than would be allowed under existing law.

Since the term "biomedical product" is not specifically defined, it is assumed that most biotech and biopharmaceutical corporations would qualify. Furthermore, many pharmaceutical marketing corporations would also qualify under this bill. Unused NOLs for these biomedical corporations is estimated to be about \$5 billion in 2004. Allowing unused NOLs to be transferred and used freely would deplete the corporate tax liability to the point that corporations receiving NOLs would pay a much-reduced measured tax or only the minimum tax. The revenue loss for 2004 is estimated to be about \$45 million, which is equal to 75% of total expected tax liability of biopharmaceutical and biotech corporations.

## ARGUMENTS/POLICY CONCERNS

- The bill requires the transferee company to continue the development and/or marketing activities. However, it does not specify how long those activities should continue. The transferee company could continue the activities for one day and literally meet this requirement.
- Although the bill requires the transferor to develop or market the product in California, this same requirement does not apply to the transferee. In addition, the bill does not require that the NOL be sourced to California. Thus, a California transferee corporation could claim an NOL deduction for losses incurred outside of California.
- Internal Revenue Code section 382, to which California conforms, has very stringent requirements regarding the utilization of NOLs following any "ownership change" of greater than 5%. These federal rules have evolved over the past 35 years in response to perceived trafficking in NOLs by corporations that have acquired loss corporations for the primary purpose of utilizing the locked NOL tax benefits inherent in such corporations. In contrast to that policy, this bill would sanction such trafficking in NOLs.

- The Congressional Joint Committee on Taxation on the subject of transferable NOLs has expressed concern that transferring or selling NOLs would effectively use the tax system to subsidize corporate losses. The Committee reasoned that the NOL provisions are intended to perform an averaging function by reducing the distortions caused by the annual account system. If, on the other hand, carryovers are transferred in a way that permits a loss to offset unrelated income, no legitimate averaging function is performed. With completely free transferability of tax losses, the carryover provisions become a mechanism for partial recoupment of losses through the tax system.

## **LEGISLATIVE STAFF CONTACT**

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